Allspring

The Sweet Spot: Why Mid-Cap Value Now

BY THE SPECIAL GLOBAL EQUITY TEAM

+ While aggregate market valuations have been coming off peak levels, evidence suggests we're in the early innings of mid-cap value relative performance.
+ Given the underrepresentation of mid caps in portfolios, the Special Global Equity team believes now is a good time to allocate to this equity sweet spot.

We have long argued that mid-cap companies sit in the "sweet spot" of a company's life cycle—more mature and diversified than their small-cap peers and nimbler than their large-cap peers. This sweet spot has allowed mid-cap companies to outperform small- and large-cap companies over longer periods.

We believe mid-cap companies should be a core allocation within equity portfolios. Some investors may question whether now is a good time to allocate assets to mid-cap value. Given that prices and entry points are an important part of investing, this paper seeks to examine this question in detail.

In 2001, Warren Buffett called the market capitalization to gross domestic product (GDP) ratio the best measure of valuations at any given moment:

> *"If the relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%—as it did in 1999 and part of 2000—you are playing with fire ... For investors to gain wealth at a rate that exceeds the growth of U.S. businesses, the percentage relationship line on the chart must keep going up and up. If GNP [gross national product[1]] is going to grow 5% a year and you want market values to go up 10%, then you need to have the line go straight off the top of the chart. That won't happen.[2]"*

1: GNP is the market value of goods and services produced by all citizens of a country—both domestically and abroad.

2: Warren Buffett and Carol Loomis, "Warren Buffett on the Stock Market," CNNMoney.com, December 10, 2001.

Figure 1 shows the relationship between total market capitalization and actual economic activity (GDP). We note that despite the recent sell-off, the indicator is just now in line with the dot-com peak.

The indicator isn't very useful for estimating short-run returns. Yet, it's a powerful indicator of what investors could expect from aggregate equity markets over the next decade.

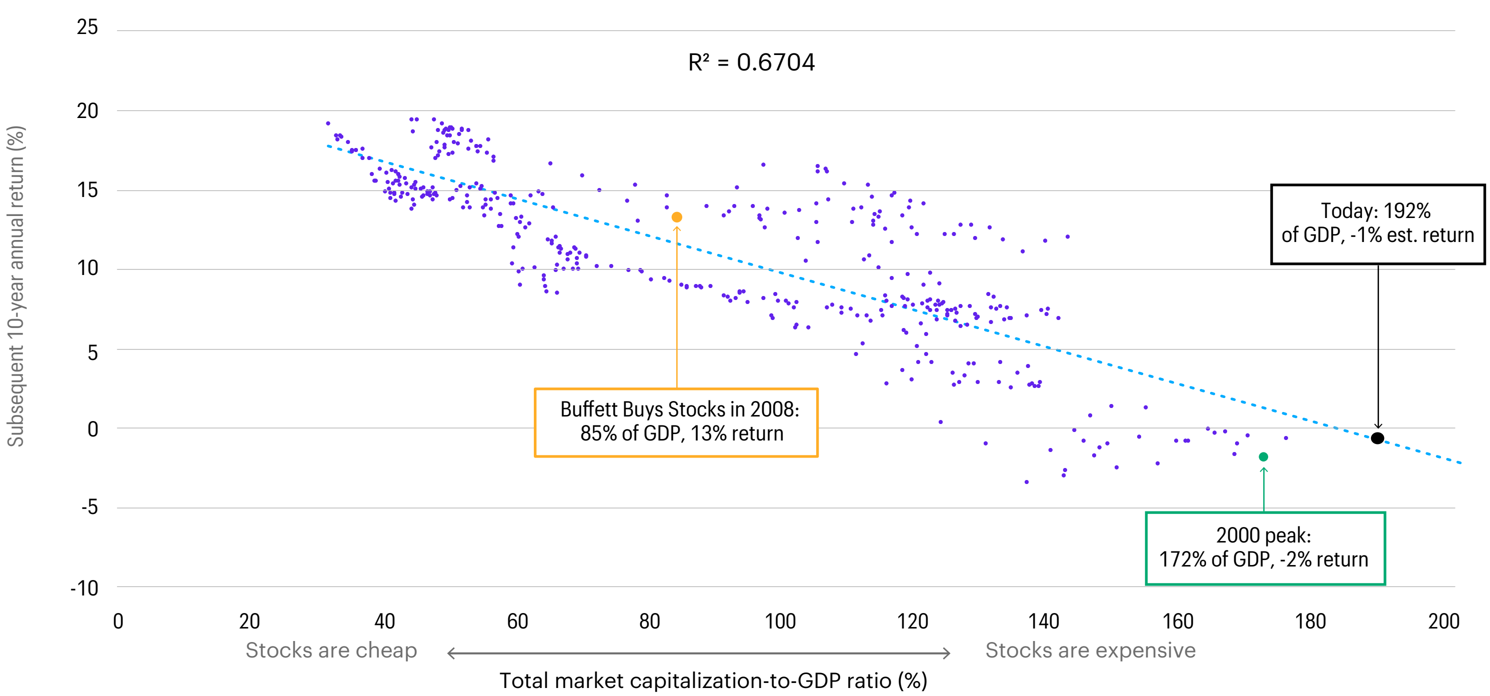
FIGURE 1: THE BUFFETT VALUATION INDICATOR: MARKET CAPITALIZATION-TO-GDP RATIO

Sources: KCR Research, Compustat, and Refinitiv, 31-Jan-81 to 31-Dec-23

We emphasize *aggregate* because the bulk of the valuation bubble driving the line has been in growth stocks—specifically, in large-cap growth stocks.

As Figure 2 shows, aggregate market valuations are at dot-com peak levels. Fortunately, the bloated valuations that have driven this measurement are primarily concentrated in large-cap growth stocks.

FIGURE 2: MARKET CAPITALIZATION-TO-GDP RATIO ACCURATELY FORECASTS THE NEXT 10 YEARS



Sources: KCR Research, Compustat, Refinitiv; data from 31-Jan-81 to 31-Dec-23

Evidence suggests the market is in the early innings of a rationalization in pricing structure when mid-cap value has historically outperformed.

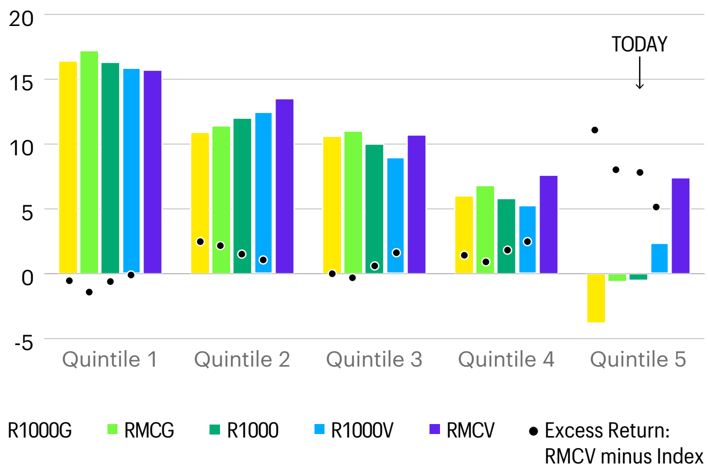
Through the rapid and sizable increase in valuation multiples as this cycle's growth mania crested over the past few years, the Russell Midcap Value Index did not participate in the outsized annual returns of large-cap growth, as measured by the Russell 1000 Growth Index. Today, mid-cap value stocks look particularly appealing relative to other equity cohorts. This is particularly true versus large growth, mid-cap growth, and large core.

Figure 3 presents a clustered bar graph showing the 10-year forward returns to various equity groups overlaid with a scatter plot depicting the excess return of the Russell Midcap Value Index. Quintile 1 shows the returns to equities when the market capitalization-to-GDP ratio is in the cheapest 20% of historical observations. Consistent with the above, when the market is very cheap, it's difficult to miss the mark. Virtually all of the different equity groups within this cheapest quintile put up strong returns of 15%+ per year in the following decade.

Moving to the right, however, notice the rapid decline in observed rates of return over the subsequent decade. By quintile 5, buying equities in the most expensive 20% of observations leaves investors with the prospect of near-zero rates of annual returns. The one outlier to this is the Russell Midcap Value Index (violet bar).

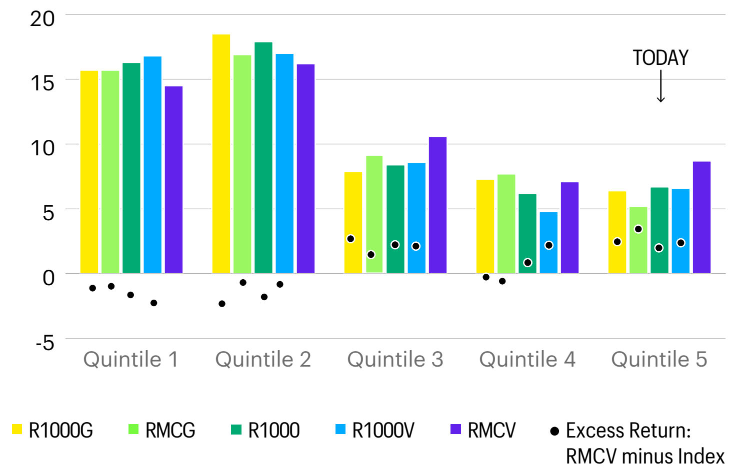
For shorter time horizons of five years, the Russell Midcap Value Index is still attractive when stocks are in quintile 5 (Figure 4).

FIGURE 3: 10-YEAR FORWARD ANNUAL RETURN BY QUINTILE OF MARKET CAPITALIZATION-TO-GDP RATIO



Sources: KCR Research, Compustat, and Refinitiv, 31-Jan-81 to 31-Jul-22 to 31-Dec-23

FIGURE 4: FIVE-YEAR FORWARD ANNUAL RETURN BY QUINTILE OF MARKET CAPITALIZATION-TO-GDP RATIO



Sources: KCR Research, Compustat, and Refinitiv, 31-Jan-81 to 31-Jul-22 to 31-Dec-23

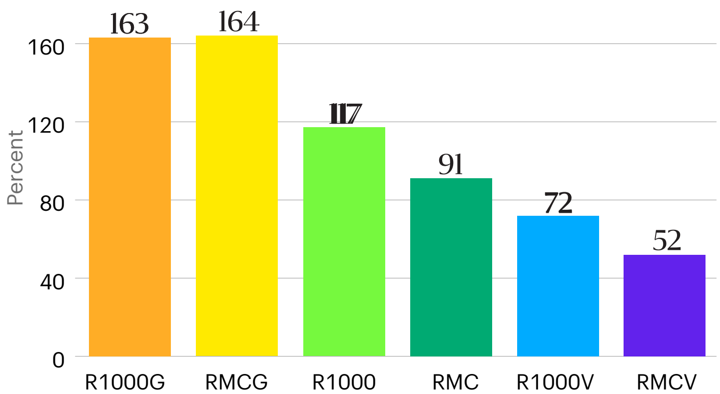
Continuing the comparison between today's market position and previous periods, we examined the 1997–2000 dot-com boom and the subsequent returns across various equity categories.

Figure 5 shows that during the dot-com bubble run-up (1997–2000 peak), large- and mid-cap growth stocks significantly outperformed their value peers. However, once the bubble burst, mid-cap value stocks went on to trounce all other equity style boxes over the subsequent 10 years.

As Figure 6 shows, in the most recent cycle, mid-cap value (and value in general) stocks have kept pace with growth stocks since the market peak, but the relative outperformance of mid-cap value observed last cycle hasn't yet occurred in this cycle. The reaccelerated performance of growth stocks in 2023 has given investors a second chance to sell the large- and mid-cap growth winners and rotate into mid-cap value and large-cap value to capture the relative performance we think lies ahead should this cycle play out similarly to the last one.

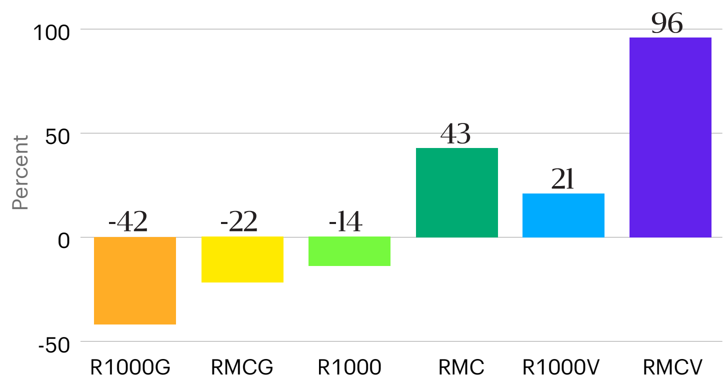
FIGURE 5: GROWTH DOMINATED FROM 1997 TO THE PEAK OF 2000; MID-CAP VALUE ESPECIALLY TROUNCED POST-PEAK 2000

ABSOLUTE RETURN: 1997–PEAK 2000



Sources: KCR Research, Compustat, and Refinitiv, 31-Dec-96 to 31-Aug-00

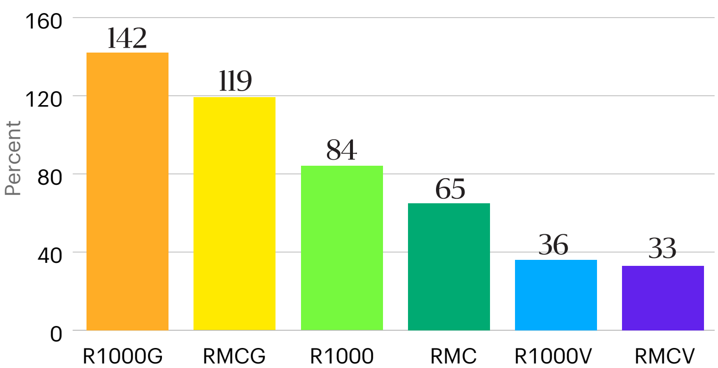
ABSOLUTE RETURN: PEAK 2000–10 YEARS FORWARD



Sources: KCR Research, Compustat, and Refinitiv, 31-Aug-00 to 31-Aug-10

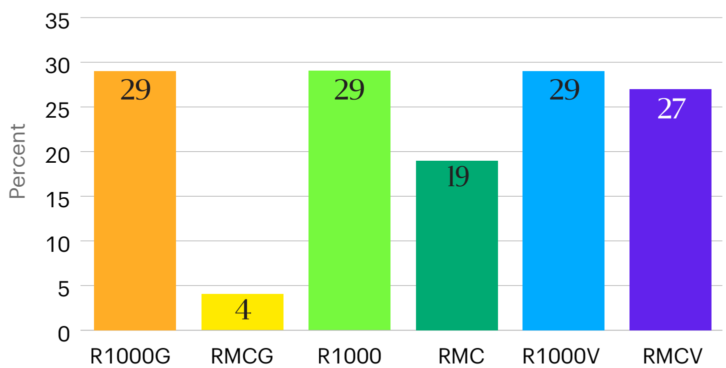
FIGURE 6: GROWTH PREFERENCE FOR 2017–2020 WAS NEARLY IDENTICAL TO 1997–2000; POST THE RECENT PEAK, IT LOOKS LIKE THERE'S STILL TIME

ABSOLUTE RETURN: PEAK 2017–2020



Sources: KCR Research, Compustat, and Refinitiv, 31-Dec-16 to 31-Dec-20

ABSOLUTE RETURN: 2021–TODAY

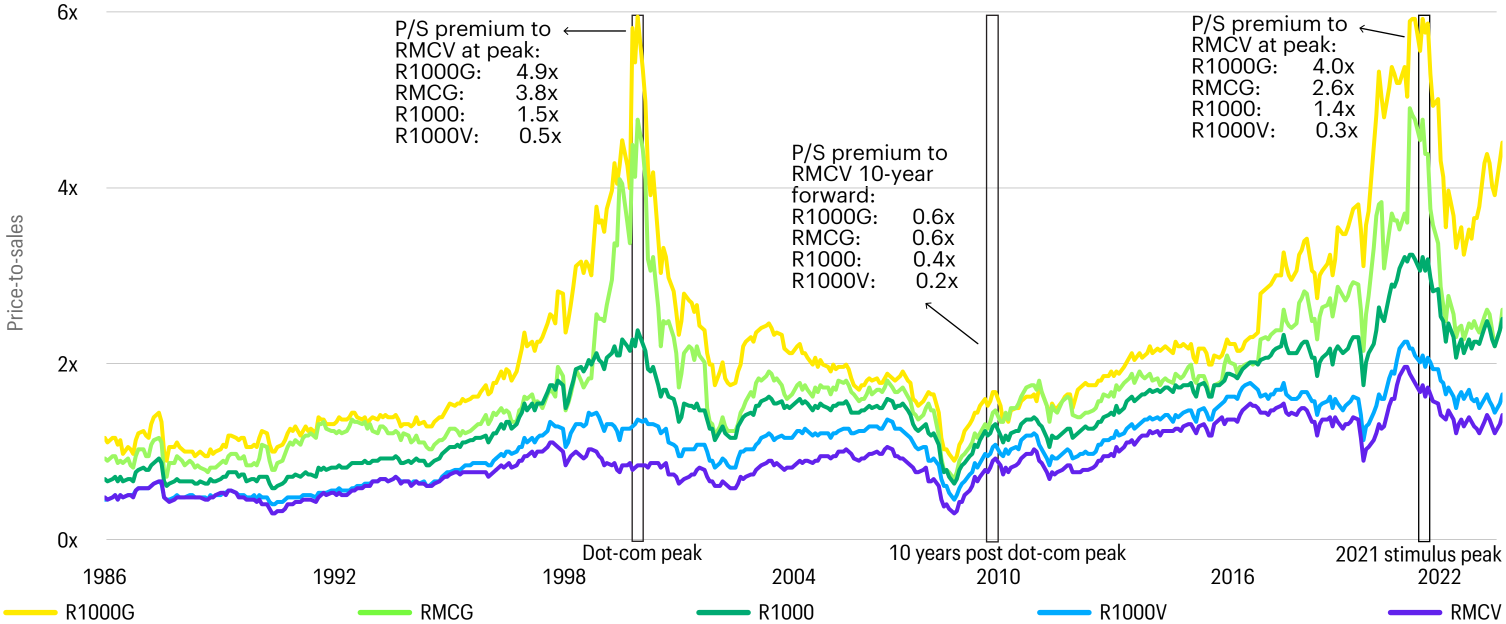


Sources: KCR Research, Compustat, and Refinitiv, 31-Dec-20 to 31-Dec-23

We believe this is still early-innings timing for mid-cap value outperformance, as valuation spreads between growth and value are still historically wide. Figure 7, which reflects the price-to-sales ratio over the past four decades, shows that valuation spreads had approached dot-com peak levels as of 2021.

The massive valuation spreads at the peak of the dot-com bubble have been almost perfectly repeated in this cycle, as measured by the price-to-sales ratio (Figure 7).

FIGURE 7: PRICE-TO-SALES RATIOS WERE SIMILAR ACROSS THE TIME PERIODS



Sources: KCR Research, Compustat, and Refinitiv, 31-Mar-86 to 31-Dec-23

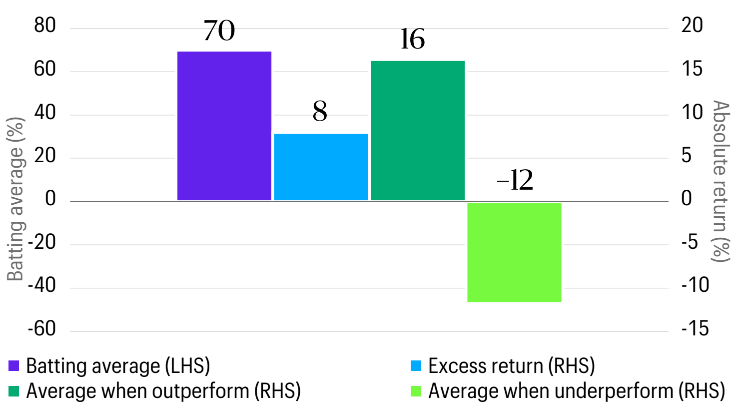
Mid-cap value had a strong batting average post valuation peak

Looking at this mid-cap value outperformance in more detail in the decade following the peak of the dot-com bubble, the Russell Midcap Value Index rose in 7 out of 10 years, for a 70% batting average (Figure 8). Over the entire decade, the Russell Midcap Value Index compounded by an average of 8% per year. In the seven years the Russell Midcap Value Index was up, it rose by an average of 16% per annum. In the three years the Russell Midcap Value Index was down, it fell by an average of 12% annually.

The Russell Midcap Value Index beat the Russell 1000 Growth Index in 7 out of 10 years (70% batting average) for the decade following the dot-com bubble. Over the entire decade, the Russell Midcap Value Index outperformed by an average of 11% a year. Annual outperformance for the Russell Midcap Value Index for those seven years was 18%, on average. During its three years of underperformance, the Russell Midcap Value Index lost by only 4% annually, on average.

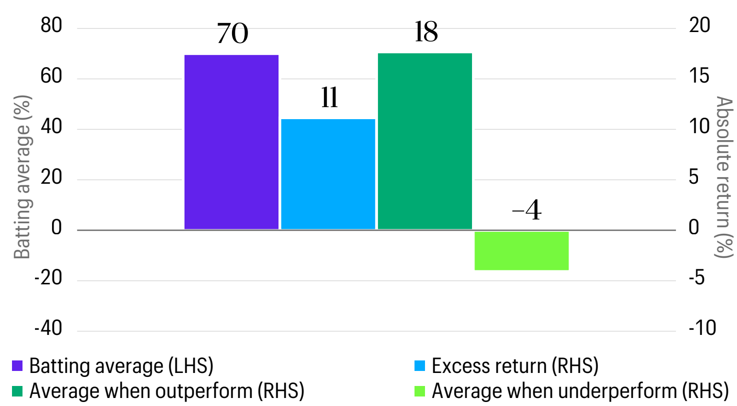
FIGURE 8: MID-CAP VALUE RELATIVE PERFORMANCE, 2000–2010

RMCV RETURN & PAYOFF STRUCTURE



Sources: KCR Research and Bloomberg Finance L.P., 31-Aug-00 to 31-Aug-10

EXCESS RETURN & PAYOFF STRUCTURE: RMCV VS. R1000G



Sources: KCR Research and Bloomberg Finance L.P., 31-Aug-00 to 31-Aug-10

Consider investing for tomorrow, with an eye on today's valuations

Markets are difficult to time, but valuations and entry points are an important part of investing. While data show that equity markets are still expensive relative to history, we believe mid-cap value stocks offer investors a chance to earn attractive returns going forward. The 2021 market peak was primarily fueled by large-cap growth multiple expansion. Our work shows that mid-cap value stocks potentially offer investors the opportunity to earn positive returns at current valuation levels.

History does not always repeat, but we believe the lessons learned from past cycles provide some valuable tools for important asset allocation decisions. For those who are still underweight mid caps compared with the broader market, this opportunity might prove beneficial to an overall portfolio. Mid-cap equity remains an under-owned category.

For those looking to make their portfolios market neutral, this may be the time, especially given the category's history of outperformance. Although mid-cap stocks comprise 24% of the U.S. market, Morningstar assets under management by category show only a 10% ownership level. For investors waiting for the ideal time to close that gap, we believe the valuation spread is at a sweet spot now.

FIGURE 9: MID CAPS ARE UNDER-OWNED

DESPITE MID CAPS' FAVORABLE PERFORMANCE, INVESTORS OVERWHELMINGLY HELD U.S. LARGE-CAP MUTUAL FUNDS AND EXCHANGE-TRADED FUNDS (ETFS)

INDEX	MORNINGSTAR CATEGORY*		U.S. MARKET CAPITALIZATION**		
CAPITALIZATION STYLE	AUM FUNDS AND ETFS ($T)	PERCENT OF TOTAL	CAPITALIZATION SEGMENT ($B)	MARKET CAP ($T)	PERCENT OF TOTAL
Large cap	11.0	82%	>47.0	37.4	72%
Mid cap	1.3	10%	4.2–47.0	12.4	24%
Mid-cap value	0.3	2%	–	–	–
Small cap	1.1	8%	<4.2	2.4	5%

*Source: Morningstar Associates, as of 31-Dec-23. Values may not add up to 100% due to rounding.

**Using the Russell 3000, Source: FactSet, as of 31-Dec-23. Market-capitalization ranges are aligned with Russell's definition as of the latest Russell rebalance in 2023.

For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains. Visit our website at www.allspringglobal.com.

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The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price/book ratios and higher forecasted growth values. You cannot invest directly in an index.

The Russell Midcap® Growth Index measures the performance of those Russell Midcap companies with higher price/book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000® Growth Index. You cannot invest directly in an index.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 92% of the total market capitalization of the Russell 3000 Index. You cannot invest directly in an index.

The Russell 1000® Value Index measures the performance of those Russell 1000 companies with lower price/book ratios and lower forecasted growth values. You cannot invest directly in an index.

The Russell Midcap® Value Index measures the performance of those Russell Midcap companies with lower price/book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000® Value Index. You cannot invest directly in an index.

The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. You cannot invest directly in an index.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. You cannot invest directly in an index.

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

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